



EMPLOYEE STOCK OPTIONS - A PRIMER

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“Stock options give the option holder the right to purchase a fixed number of shares in a company at a set price during a specific time period.”

1 OVERVIEW

Stock options give the option holder the right to purchase a fixed number of shares in a company at a set price during a specific time period. Stock options received as compensation for services, whether as an employee or independent contractor, fall into two categories for tax purposes: (i) incentive stock options or (ii) non-qualified stock options. The main difference between these two types of options is that once the option is exercised, the stock received under an incentive stock option has the potential of being taxed at the more favorable long-term capital gains rate, while stock received by exercising a non-qualified stock option is taxed at ordinary income tax rates.

These stock options, however, have numerous conditions and restrictions imposed by the company and by the Securities and Exchange Commission (“SEC”) - the Agency with jurisdiction over the stock market.

2 DEFINITIONS

2.1 Basic Stock and Option Concepts

“Options” give you the right to obtain a set number of shares of stock at a fixed price (called the “strike price”) during a fixed time period. This is sometimes called a “call” option. A “put” option gives you the right to sell stock at a certain price.

“Stock” means a stock certificate that constitutes a right of ownership in a corporation. The owners of stock are called stockholders or shareholders and they own 100% of the corporation. A stockholder’s percentage ownership of a corporation is calculated by comparing the number of shares owned by the stockholder to the total number of shares issued and outstanding to all stockholders.

“Vesting” means obtaining the legal right to a benefit without restrictions imposed by the company. When an option or stock

4 THE 4 MAJOR POINTS PERTAINING TO COMPENSATION STOCK OPTIONS



4.1 Early Exercise and Sec. 83(b)

Before joining a company offering stock options, you want to ensure that you can make an election to exercise your options early and then elect to be taxed on the spread under IRC Sec. 83(b). This combination will reduce your taxes to the minimum and will maximize your long-term capital gains. Also, there is no AMT issue when ISOs are exercised.

For example, if you have an option to acquire 10,000 shares at \$0.08/share and the stock price is \$0.10/share when you exercise your option, it will cost you \$800 to exercise the option and you'll have \$200 of income.

If you wait until the stock is worth \$1.00/share, you'll still pay \$800 but your income will be \$9,200. At \$10.00/share, your income will be \$92,000. Thus, exercising your options at the earliest possible time, when the spread is the smallest, is the single most important tax consideration.

4.2 You Begin in the Hole



“Remember, with stock options, you are always in the hole. Think of stock options as playing poker: You need to ante-up before you can play; thus, you are in a loss position right off the bat.”

Remember, with stock options, you are always in the hole. Think of stock options as playing poker: You need to ante-up before you can play; thus, you are in a loss position right off the bat. The challenge is to minimize your loss position -- i.e. pay the smallest ante:

In the example above, if you have a choice between two companies, and both offer you 100,000 options where one has an exercise price of \$0.10/share and the other is \$2.00/share, choosing the \$2.00/share company will cost \$200,000 to exercise the options, versus \$10,000 for the other offer. In general, you want the lowest option price and the smallest spread.